ON THE DRY SIDE XXXVIII

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CHOOSING THE RIGHT INDEX.

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I came across a little academic tiff which is as relevant as any argument can be to the biggest of all Australian economic obstacles - wages. It goes like this: Professor Renshaw, [Indexation] " will allow wages to rise in response to upward shocks resulting from bad weather, world-wide food shortages, productivity slumps, and the monopolistic pricing policies of the international oil cartel. In the past most efforts to control prices and wages directly have broken down because there was no mechanism to protect the purchasing power of workers from this kind of shock".

Professor Schwartz, " But such supply shocks reduce the total real GNP; they affect the real income of all sectors. If the real wage unit is not allowed to fall, all the adjustments must take place in the other variables. Both empirically and in theory, the results are clear. There will be a rise in unemployment, a decrease in the real return on capital, and a subsequent fall in the rate of investment, capital formation, and growth. In short - the exact prescription for stagflation."

Last year bad weather, monopolistic pricing practices (mostly Australian), and the world resources slump caused our GNP to fall by about 2 percent. Professor Schwartz's argument shows the injustice of full wage indexation to 700 thousand unemployed. With all due respect to the summit; ' industrially acceptable wage indexation ' is nonsense. With all due respect to the unions, ' catch up ' is nonsense. It is profits and employment which need to catch up.

(Since we are to have indexed wages, no doubt with a little on the side for the most militant unions, the choice of index is crucial lest we get even more unemployment.) Recent union, employer and government submissions to the Arbitration Commission were based upon the Consumer Price Index (CPI). It is not suitable and could institutionalise stagflation so that we never recover.

Federal politicians are on the whole very well served by the parliamentary library and particularly by the legislative research service. Properly used, it can be invaluable to oppositions and for seven years it provided this government back bencher with the basic information he needed to question an economic management with which he became increasingly disenchanted. A recent brief (No.7 1983) dissects the CPI very tidily.

It points out that the CPI is neither a measure of inflation nor of the cost of living, but of a parcel of goods and services which, while not arbitrarily chosen, is not universally relevant either. In particular, changes in the cost of this parcel are a poor measure by which to determine minimum legal wages.

The ingredients of the parcel are fixed by the statistician in a way that the statistician's wife would never accept. If the price of beef were to increase relative to the price of pork, she, being the sensible lady that she is, would buy more pork and less beef. The CPI has no such inbuilt common sense. It goes on buying beef. Unable to change weightings to reflect those changes in consumer choice which reflect changing relative prices it over-states percentage increases in the cost of living.

The CPI does not distinguish between price rises that are merely the changing value of Australian money (inflation) and those which reflect real loss of purchasing power. The former may affect the distribution of the economic cake should people be affected unequally by the price changes; the latter reflects the size of the cake itself. When the 1973-74 oil price hike hit Australia the price of those things we exported did not similarly rise. Australia lost real income - the cake got smaller because of an adverse shift in our terms of trade. The oil price hike was reflected in the CPI, and to the extent that it was then reflected in wages it insulated those who kept their jobs from bearing a share of this loss, increasing the share borne by non-indexed incomes and the resultant unemployed.

A similar situation arose when the drought made our cake smaller. A market economy spreads the costs of natural disasters by increasing prices in response to shortages. If some are insulated against loss, then others must bear a bigger share - the non-indexed incomes and unemployed again.

Some goods and services are financed with taxes. The consumer buys these at less than cost, or free. The Western Australian government has placed a tax on tobacco products and is opening a loss making railway line from Perth to Fremantle. The benefits of the railway are not in the CPI, but the Tobacco Tax is. Reference to the CPI alone indicates reduced living standards. But we all hope that no government would deliberately reduce our standard of living, so we must assume that W.A. people will have gained when the government transfers money from tobacco to railways.

Although health costs actually rose, introduction of Medibank reduced the CPI. Payment through the tax system just took most health costs from the CPI basket. Indirect taxes affect the CPI; income tax does not. In spite of the obvious difficulties with income tax at its present levels, fear of increasing the CPI and hence wages, has prevented tax reform.

If our economy becomes uncompetative we must devalue our currency. Devaluation raises domestic prices. If domestic prices then raise wages we remain uncompetative and must devalue again and so on until non-indexed incomes have fallen sufficiently to restore competativeness.

If the CPI is to be used to adjust wages, we should exclude the effects of the terms of trade, taxes, and devaluation, from it.